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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1940

No. 699

GILBERT MOODY, JAMES H. JORDAN and WALTER J. SELBY,
Petitioners,

vs.

JAMES IRRIGATION DISTRICT, Debtor,
Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI to the United States Circuit Court of Appeals for the Ninth Circuit.

The above-named debtor acknowledges receipt of a copy of the petition for writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit and the brief in support thereof, together with a copy of the record prepared by the Clerk of said Circuit

Court of Appeals, and respectfully submits this reply to said petition and to the brief in support thereof.

This was one of five cases argued together before the Circuit Court of Appeals for the Ninth Circuit in February of 1940, and decided by that Court after careful consideration September 5th. Petitions for rehearing were filed in all the cases and were all denied October 15th. Petitions for certiorari have been heretofore filed in this Court in two of these cases, and both were denied January 6, 1941. These cases were entitled in this Court

> *Pacific National Bank v. Merced Irrigation District,* No. 591,

hereinafter referred to as "the *Merced* case", and

> *Newhouse v. Corcoran Irrigation District,* No. 589,

hereinafter referred to as "the *Corcoran* case".

In deciding these five cases, the Circuit Court of Appeals relied upon and followed the decision of this Court in

> *United States v. Bekins,* 304 U. S. 27, 58 S. Ct. 811, 82 L. Ed. 1137,

upholding the constitutionality of what was then designated Chapter X of the Bankruptcy Act, now designated as Chapter IX of that Act as revised by the act approved June 22, 1938. In that decision, this Court determined not only that the new addition to the Bankruptcy Act was constitutional, but that its provisions were applicable to the Lindsay-Strathmore Irrigation District, a district organized and existing under what is know as the California Irrigation District Act.

It appears from the findings of fact in this case (R. pp. 67 and 68) that James Irrigation District was organized and exists under the same act as the district involved in the *Bekins* case.

THE ESSENTIAL FACTS.

This case arises pursuant to the confirmation by the U. S. District Court for the Southern District of California of a plan of composition of the outstanding indebtedness of James Irrigation District, which was accepted by creditors holding more than 99 per cent of the outstanding warrants and more than 97 per cent of the outstanding bonds which constituted the indebtedness of the District. (R. p. 86.) These warrants and bonds were of the total face value of $1,016,954.75. (R. p. 79.) The text of the plan of composition and the pertinent facts about the District are set forth in the Findings of Fact and Conclusions of Law given in full in the Record, beginning at page 66.

ISSUES INVOLVED.

On pages 11 to 13 of the petition herein are set forth six questions and six reasons for granting the writ. These points, as they are further explained in the brief in support of the petition, will be considered as succinctly as possible in this reply.

The Petitioners for the writ are hereinafter referred to as "the Petitioners".

I. THE CREDITORS WERE PROPERLY CLASSIFIED AS OF ONE CLASS AND ENTITLED TO SHARE ALIKE IN THE AVAILABLE FUNDS UNDER THE PLAN OF COMPOSITION.

The first question presents the issue that the Court below did not properly classify the claims of creditors. The same contention was made as the fifth proposition in the *Merced* case and disposed of at pages 671 to 674 of Volume 114 of Federal Reporter, Second Series.

In its decision in this case (R. pp. 128 and 129), the Circuit Court of Appeals refers to the fact that the point was made in the *Merced* case "and there decided contrary to the contenders' position". The Appellants contended, however, that the facts in the *James* case were different from those in the *Merced* case, and after a statement of their position, the Circuit Court of Appeals said:

> "But we decided in the Merced case that due bond interest and principal does not become preferred claims when presented and registered as provided by Section 52 of the California Irrigation District Act. Had the District proceeded in its course as a solvent entity, the holders of overdue bonds and interest would have been paid in accordance with Section 61a of the California Irrigation District Act. But it did not and could not have so proceeded, and it resorted to the bankruptcy law for relief."

Emphasis is laid by the Petitioners here on the fact that they are the only creditors who ever presented any matured claims to the Treasurer of the District. In view of the insolvent condition of the District and the vast number of bonds and coupons which had ma-

tured and could not be paid, as shown by the Findings of Fact, most of the creditors deemed it an idle act to present their matured bonds and coupons to the Treasurer for payment. But Petitioners sought to gain a technical advantage by presenting certain of their bonds and coupons to the Treasurer and at least some of them were registered, as provided by Section 52 of the California Irrigation District Act, which, together with Section 61a of the same Act, is quoted in full in the margin on page 673 of 114 Fed. (2d).

The Petitioners state that the California law provides that the obligations of an irrigation district shall be paid "in the order of their presentation to the Treasurer after maturity", basing this statement on

Bates v. McHenry, 123 Cal. App. 81, 10 Pac. (2d) 1038.

That was a decision by the Third District Court of Appeal of California on an application for a writ of mandate to compel the Treasurer of Merced Irrigation District to pay certain matured coupons for which he had funds on hand. He had refused to pay the coupons on the ground that he did not have money enough to pay all then due, but the Appellate Court decided that Section 52 required the Treasurer to make payment in full of the matured coupons presented until the entire fund in his hands available for that purpose was exhausted, "and then to forthwith proceed to register any and all interest coupons on which payment is not made, if so demanded by the holder thereof". In its opinion the Court went on to say:

> "Thus absolute equity is meted out between the coupon holder who receives instant payment and the coupon holder whose payment is deferred."

This was explained by the fact that those who did not receive payment in cash would be compensated by receiving interest at the legal rate of 7 per cent per annum on the amount of their coupons.

The procedure for the payment of registered coupons was not an issue in the case. The Court said it was not necessary to set forth the method of payment further than to state that the registered coupons or bonds would follow the same procedure as was provided in Section 61a of the Act for registered warrants and the Court followed this with the remark that the holders thereof were entitled to payment "immediately upon funds coming into the hands of the Treasurer of the District available for such purpose and in the order in which they were registered".

Under the circumstances of that case, this remark was clearly dictum and a careful reading of Section 61a shows that the Court did not accurately summarize the provisions of that section, which clearly provides, with reference to warrants, that whenever there is sufficient money in the treasury to pay *all* the warrants that have been registered, or, if the Board so orders, all such warrants presented for payment prior to a certain date, the Treasurer shall give notice and "upon the presentation of *any* warrant entitled to payment under the terms of such notice, the Treasurer shall pay it, together with interest thereon".

The obvious purpose of both Section 52 and Section 61a was to provide for equality of treatment to the creditors of an irrigation district in case of a temporary default. There was no application for hearing before the State Supreme Court in that case, but in several cases coming before the Supreme Court in later years the dictum in *Bates v. McHenry* to the effect that registered coupons should be paid "in the order in which they were registered", has been quoted, although in none of these cases was the order of payment of registered coupons an issue to be decided. As a matter of fact, in all of these cases the State Supreme Court cited *Bates v. McHenry* to show that no bondholder was entitled to preferential treatment.

Petitioners lay stress on the decision in

Provident Land Corpn. v. Zumwalt, 12 Cal. (2d) 365, 85 Pac. (2d) 116.

That was an action by a bondholder to set aside the purchase by Provident Irrigation District of some of its unmatured bonds which had been bought with $10,000 taken from the General Fund of the district under a declaration of the Board that the money was "surplus funds". The decision of the Supreme Court was on appeal from a judgment by default following the sustaining of a general demurrer to the complaint. Therefore, the only issue in the case was whether the purchase of the bonds under the circumstances alleged in the complaint was valid. The Court said that if a surplus did exist over and above the operating needs of the district, it should not be given to junior bondholders in preference to those with prior claims, "but

should be paid on past due bonds and coupons in the order of their registration".

To understand this paraphrase of the dictum in

Bates v. McHenry (supra),

we must refer to the facts as stated in the complaint and summarized in the Court's opinion, from which it appears that Provident Irrigation District had an area of some 22,805 acres and that while it was in serious financial difficulties, only 10,000 acres had been taken by the district under tax deed. Therefore, the Court could not conclude from the complaint that the district was hopelessly insolvent. Further on in the opinion, the Court supposes a case where "the assessment method has disappeared as a means of collecting revenue" and it refers to its decision in

Kerr Glass Mfg. Corpn. v. San Buenaventura, 7 Cal. (2d) 701, 62 Pac. (2d) 583,

"where we recognized the justice of applying equitable principles to the payment of bondholders in unusual circumstances, notwithstanding the fact that express provisions of the statute stood in the way".

It is not surprising, therefore, to find that when the construction of Section 52 of the California Irrigation District Act came again before the Third District Court of Appeal in

Clough v. Baber, 38 Cal. App. (2d) 50, 100 Pac. (2d) 519,

in a case in which it was admitted that the district was insolvent and that its taxing power had been exhausted, and that to construe the section literally would no longer mete out "absolute equity" to the

bondholders, the Court determined that the Petitioner was "not entitled to payment in full of his five registered bonds as a preference, but the available funds should be apportioned pro rata among the holders of all valid claims". Counsel for Petitioners here was counsel for certain intervenors in that case and application was made to the Supreme Court of the State for a hearing after a decision by the Third District Court of Appeal, but the application was denied although the importance of the issue involved was forcefully presented to the Supreme Court.

We therefore have a decision by the same Court which decided the case of

Bates v. McHenry (supra),

holding that when an irrigation district is insolvent and the literal application of Section 52 can no longer mete out "absolute equity" to the bondholders, the State Courts must apply equitable principles to the distribution of the available funds among those entitled to them. Much more then must a bankruptcy Court disregard a legal claim to technical preference and make its classification of creditors in the light of the obvious purpose of the law that all bondholders should be treated alike.

Chapter IX of the Bankruptcy Act provides that a plan of composition cannot be confirmed unless it is found to be "fair, equitable and for the best interests of the creditors and does not discriminate unfairly in favor of or against any creditor or class of creditors". The Petitioners here base their plea for a writ of certiorari on the express ground that the District's

plan of composition *does not discriminate in their favor.*

This naive contention becomes the more absurd in the light of the conditions which forced the District into the Bankruptcy Court. In the opinion of the Circuit Court of Appeals (R. p. 127) its taxing power was described as having become practically exhausted, leaving the bonded indebtedness outstanding, "the clearest possible case of insolvency", and the following from that Court's opinion (R. p. 133) is equally significant:

> "It must be remembered that this is not a procedure in liquidation and the principles to be applied must differ somewhat from such proceedings. In liquidation it is perfectly evident that the creditors would get almost nothing."

II. PETITIONERS' SECOND POINT IS MADE HERE FOR THE FIRST TIME.

The second point made by the Petitioners is that, because the District owns practically all the land within its boundaries, the Plan of Composition should have offered the creditors not only the full amount of the loan authorized by the Reconstruction Finance Corporation, but also the land which the District owned.

It is a sufficient answer to this contention that it is made for the first time in this Court. The Record will be searched in vain for any indication that any such idea was even suggested in either of the Courts below.

There is no showing that the bondholders had any desire or fitness to become landowners. Had the land been given to them, it would have become subject to taxation to pay maturing interest and principal of the bonds issued to evidence the loan, and one witness testified without contradiction (R. p. 62) that if all the land in the District were free of any bonded indebtedness it would be worth "not more than $250,000", or a little less than the amount of the loan. It would therefore have been backhanded generosity to have offered the land to the bondholders and thus made them subject to taxation to repay the loan, which H. E. Vogel, a member of the California Districts Securities Commission, testified (R. p. 64) "was well up to the limit of the ability of the lands in the District to meet".

Petitioners argue, however, that under the law of California, the loan could not exceed 60 per cent of the value of the works and water rights of the district plus the value of the land within its boundaries, and they point to a report of the California Districts Securities Commission (R. p. 49) estimating the value of the works and water rights at more than $1,000,000, and the value of the lands at in excess of $960,000.

The same legal limitation prevailed when the original bonds were issued, but it did not prevent the issuance of bonds in the amount of $1,000,000, which the District found it impossible to pay. The proceeds of the old bonds were all expended for the works and water rights of the District, which is obviously the basis of the Commission's "estimate" that they were

worth in excess of the amount of the bond issue, and it appears (R. p. 19) that the total amount of the District's assessment roll at the time of the hearing was $967,450, which accounts for the Commission's estimate of over $960,000 as the value of the land. These figures cannot impair the sworn testimony of experts, who showed intimate knowledge of the District, that the loan was substantially all that the District could be expected to pay. If Petitioners had really thought the land was actually worth more than the amount of the loan, they had full opportunity to offer testimony to that effect, but none was forthcoming.

Furthermore, the works and water rights of the District are not assets available to the bondholders, who are limited to the lands in the District as the source of revenue from which their obligations are to be paid. This was determined in the *Corcoran* case (supra) in which certiorari was denied by this Court January 6th of this year.

Furthermore, an act authorizing an irrigation district to mortgage its properties as additional security for bonds was declared unconstitutional in

Merchants National Bank v. Escondido Ir. Dist.,
144 Cal. 329, 77 Pac. 937.

III. THIRD POINT HAS ALREADY BEEN DECIDED AGAINST THE PETITIONERS.

The third point is based on the contention that the Supreme Court of California has recently determined that the functions of an irrigation district are ex-

clusively governmental and therefore Chapter IX of the Bankruptcy Act cannot be applied to such a district.

The point was held to be without merit by that Court in the recent case of

People's State Bank v. Imperial Ir. Dist., 15 Cal. (2d) 397, 101 Pac. (2d) 466,

in which it was pointed out that the governmental nature of irrigation districts had been established by Court decisions long before the decision of this Court in

United States v. Bekins (supra).

The point was also made in the *Merced* case at page 662 of 114 Fed. (2d) and rejected by the Circuit Court of Appeals.

IV. THE STATE HAS NO LIABILITY FOR DISTRICT BONDS.

The fourth point of the Petitioners is based on the fact that James Irrigation District had acquired by delinquent tax proceedings title to practically all the land in the District and had further acquired the State's title to the same property, which had also been sold to the State for delinquent county taxes. This was in pursuance of the requirement of special condition No. 4 of the resolution adopted by the Reconstruction Finance Corporation authorizing the loan to the District, that the lands within the District should be relieved of all delinquent taxes other than irrigation district assessments. (R. p. 24.)

Petitioners, at page 32 of their brief, cite

Anderson-Cottonwood Ir. Dist. v. Klukkert, 13 Cal. (2d) 191, 88 Pac. (2d) 685,

to the effect that the property of an irrigation district is really the property of the State, and therefore is not subject to local taxation as long as the title is held by the District. It is, therefore, argued that the State has become the creditor and cannot give its consent to the bankruptcy plan for its own benefit.

An irrigation district is an agency of the State, but the State does not thereby become responsible for the indebtedness of such a district. It is simply not true, as stated in Question 4 on page 11 of the petition herein, that "the bonds which are the subject of the composition plan are issued by the State". They are certified by the State Controller as legal investments for trust funds and banks, but they are issued by the District on authorization by a vote of the electors of the District. It has never been held that the District's bonds are bonds of the State or that the State has any liability with regard to them. The ownership of tax-deeded land by the District is only temporary and James District was expressly required by condition No. 1 of the resolution of the Reconstruction Finance (R. p. 23) to return substantially all of the irrigated lands to private ownership.

It is shown in the Findings (R. p. 78) that nearly all the land owned by the District has been sold on contract to private purchasers, who have thus become the equitable owners of the land, and this destroys the

argument that the State is the real owner of the land and cannot consent to the bankruptcy proceedings.

Petitioners, however, at pages 31 to 33 of their brief, advance the novel theory that the District should have held the land in public ownership and paid no taxes, but rented it out and given the rentals to the bondholders. Of course, under this plan no loan could have been obtained, for it was one of the conditions of the loan that the land should be restored to private ownership, and it would be absurd to suppose that an area of over 24,000 acres could be permanently withdrawn from the local tax rolls, and continue to enjoy the advantages of roads, schools and police protection at the expense of other taxpayers of the county.

Furthermore, this point, like the point that the plan of composition should have offered the bondholders both the land and the loan, is presented here for the first time. It is an obvious afterthought and indicates that the Petitioners are not quite sure whether they want to own the land or want the District to own it and keep it off the County tax rolls and give them the rentals from it. Either scheme would have been impracticable.

V. THE STATE'S CONSENT TO THE FILING OF PETITIONS BY DISTRICTS UNDER THE BANKRUPTCY ACT IS NOT FORBIDDEN BY THE STATE CONSTITUTION.

This Court held in the *Bekins* case that if the consent of the State to the filing of a petition in the

bankruptcy Court by Lindsay-Strathmore Irrigation District was necessary, such consent had been given by Chapter 4 of the Statutes of the Extra Session of 1934. The fifth point in the petition for certiorari herein is that the State is prohibited by its own constitution from consenting to bankruptcy relief, the contention being based on constitutional provisions against the surrender of taxing power, impairment of contracts, delegation of judicial authorities and taking private property without just compensation.

The same points were made by the same counsel appearing for the Petitioners here before the Supreme Court of California in

People's State Bank v. Imperial Ir. Dist. (supra),

in an action for an injunction to prohibit Imperial Irrigation District from instituting proceedings in the U. S. District Court for the confirmation of a plan of composition with its creditors. The State Court denied the injunction and declared that it was in thorough accord with the views expressed by this Court in the *Bekins* case "particularly in respect to its conclusion as to the constitutionality of the statute of our own State".

The State Supreme Court then summarized the argument for the Plaintiff on constitutional grounds and said:

> "This same argument was made before the Supreme Court of the United States in the Bekins case, and we understand by the same counsel now representing the appellants in the

instant case. Some of them were answered by that court and others were evidently not thought of sufficient importance to require an answer. Undoubtedly the Court considered each and every one of them and found that none of them was meritorious."

The State Supreme Court also referred to the fact that Chapter 4 of the Statutes of the Extra Session of 1934 was repealed in 1939, but with an express proviso that its repeal should not impair any action or proceeding commenced while that chapter was in effect, and in the same act it was provided that the State consented to the application of Sections 81 to 84 of the United States Bankruptcy Act "to the taxing agencies and instrumentalities of this State". Therefore, the Court concluded that, whichever of the two statutes might be applicable to the proceeding then pending, the State had given its consent to the filing of the petition.

The same argument was also made and rejected in the *Merced* case (114 Fed. (2d) at p. 665).

VI. THE BONDS PURCHASED BY R. F. C. ARE STILL OUTSTANDING.

The sixth point of the petition is based on the fact that over 90 per cent of the bonds of James Irrigation District were held at the time of the filing of the plan of composition by one corporation, and afterwards purchased by the Reconstruction Finance Corporation,

from which the Petitioners argue that the plan has to that extent been executed. The old bonds, however, are still held under a contract with the District, which is set forth in the Record beginning at page 26, and provides (R. pp. 27 and 28) "that R.F.C. may, in its discretion, keep any part of said indebtedness alive for the sole purpose of maintaining a parity between itself and the holders of indebtedness of said borrower who have not agreed to enter into the refinancing scheme of said borrower, or for any other purpose".

A similar provision in such a contract was considered by the Circuit Court of Appeals for the Eighth Circuit in

Luehrmann v. Drainage District No. 7, 104 Fed. (2d) 696,

and it was held that the Reconstruction Finance Corporation was a creditor affected by the plan of composition of the drainage district in the full amount of the bonds so purchased. A writ of certiorari was denied in that case in this Court November 6, 1939, under the title

Haverstick v. Drainage District No. 7, 308 U. S. 604,

and it is therefore settled that under such circumstances the Reconstruction Finance Corporation, as the holder of old bonds, is a creditor of the district and that the indebtedness represented by the old bonds has not been settled pending the completion of the district's refinancing plan.

In view of the fact that no proper showing has been made of any reason why a writ of certiorari should

issue, and in view of the unanimity of the decisions of various circuit courts in upholding the new Chapter IX of the Bankruptcy Act, James Irrigation District respectfully prays that the petition for the writ be denied.

Dated, Stockton, California,
February 3, 1941.

A. L. COWELL,
Counsel for Respondent.